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for Central and Eastern Europe and the New Independent States

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Agnieszka Talma: agnieszkat@mfc.org.pl

MFC's Microfinance Policy Work. Expanding Inclusive Financial Systems:

10 Years of Promoting Policy Change

Microfinance actors operate in an ever-changing policy environment and have to act and react accordingly. Since its inception, the Policy Monitor has provided timely insights into a wide range of policy issues affecting microfinance in the Central and Eastern European and Central Asian regions. This issue of the Policy Monitor provides a good example of the publication's ability to draw on the vast knowledge and experience of practitioners, researchers and policymakers to present important and relevant discussions of microfinance policy. The issue includes articles on agent-assisted branchless banking, the results of a benchmarking study conducted in Central Asia by the MIX and the Central Asia Microfinance Center, the legal framework for microfinance in Romania and the findings of a demand study conducted by MFC in Poland. The last article highlights MFC's participation in the UN Advisors Group on Inclusive Financial Sectors that contributes to and positively influences the microfinance policy decision-making process.

The MFC Network

MFC is a network organisation, and growing membership has strengthened its ability to impact microfinance policy. The last 10 years have seen a considerable focus within the microfinance industry on financial performance. Although financial performance is essential to ensure the continued provision of microfinance services, MFC is currently using its position within the industry to advocate for a proper balance of costs and benefits and promote **social performance management**. This is an especially important issue at a time when a growing number of investors are attempting to assess the social impact of MFIs. National and international microfinance policy may soon reflect this interest in social performance management. MFC's efforts in this area demonstrate its value as a network organisation that can influence microfinance policy now and in the future.

New Look for the Policy Monitor

Upon the 10th anniversary of MFC, we are pleased to announce a new direction for the Policy Monitor. Thanks to a huge response to our readership survey, the Policy Monitor will be relaunched and each future issue will focus on a particular policy topic in which our readers have expressed an interest. The articles will continue to draw on MFC's wide experience within the Region, but their scope will be expanded to include discussions of issues from across the globe. Contributions will be reviewed by the recently formed editorial board, headed by Lee Byrd, a Policy Advisory Consultant to CGAP.

I would like to take this opportunity and thank the Open Society Institute for providing support to this important publication.

Grzegorz Galusek, Executive Director, MFC

CENTRAL ASIA

MIX and CAC Central Asia Benchmarking Study

Olga Tomilova

Manager, Central Asia Microfinance Center – joint Initiative of MFC and CGAP

Scott Gaul,

Lead Analyst, MIX

The Central Asian republics of Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan are home to more than 1,000 institutions offering microfinance services. The microfinance sector operates at two levels: a few large foreign funded institutions and hundreds of small local institutions.

The republics are characterized by low population density, transition periods after communist rule and some of the lowest income levels in the world. Access to financial services is weak throughout the region, and there is a noticeable absence of mechanisms to facilitate the growth of microfinance. Country-level networks are young, few credit bureaus exist, few MFIs have been externally evaluated and there is limited access to domestic and foreign finance.

The 2005 benchmarking study looks at differences in outreach, sustainability and growth across a range of microfinance institutions (MFIs) in the region. The report gives an overview of the microfinance sector in each republic and examines the factors contributing to microfinance development in each republic, giving consideration to differences between the countries' legal and regulatory frameworks.

Overview of microfinance within each country

Kazakhstan

In Kazakhstan, four types of legal entities provide microfinance. Banks reach a total of 54,000 microcredit borrowers. Credit partnerships have a combined portfolio of USD 20 million. NBFIs and microcredit organisations offer services to poorer clients, who account for 37% of all lending opportunities. For 2005 through 2007, the government has dedicated USD 87 million for microfinance through their "Fund for Development of Small Enterprise." During the last five years, the government has also introduced specific microfinance laws:

- the Law on Microlending Organizations, and
- the Law on Credit Partnerships.

The legal entities provided for in these laws face lending restrictions, but the Law on Microlending Organizations was amended at the end of 2006 to increase the maximum loan amount from approximately USD 8,200 to approximately USD 67,000.

The government has established a credit bureau, which gathers data from 29 commercial banks and covers 5.5% of the population.

Kyrgyzstan

In Kyrgyzstan, the microfinance sector is composed of credit unions, MFIs and a few downscaling banks. Four MFIs dominate the sector, and scale of all other MFIs is significantly lower. Credit unions have an average of 70 borrowers and an average loan portfolio of USD 50,000. In 2005, the government implemented the "Medium Term National Strategy for the Development of Microfinance, 2005 – 2009."

All types of microfinance providers are regulated by the National Bank of the Kyrgyzstan Republic.

In 2003, the government established a credit bureau, which by 2006 had 41,000 credit histories and covered 2.3% of the population.

Tajikistan

Microfinance in Tajikistan developed mainly as a result of assistance from the international development community. The average loan size in the country is USD 292. The First Microfinance Bank began operations in 2003, and it now has 7,000 borrowers and an outstanding portfolio of USD 6 million.

Microfinance law is modelled on that of Kyrgyzstan and has 3 layers:

- Credit-only not-for-profit institutions,
- Credit-only for-profit institutions, and
- Credit and deposit for-profit institutions

Tajik law imposes a maximum loan size of approximately USD 20,000 and allows MFIs to lend only to individuals and licensed legal entities.

Uzbekistan

Among the four republics, Uzbekistan has the smallest microfinance sector, with 27 MFIS and a small number of credit unions. The sector has 65,000 active borrowers, with an average loan size of USD 140. The major change in the last year has been the transformation of the state-run Tadbirkor Bank to a specialized microfinance bank.

In 2006, laws on microfinance and microcredit organizations were enacted.

Restrictions exist on nominal interest rates, but not on effective interest rates. Specific restrictions also exist on the use of cash.

Overview of microfinance in the region as a whole

The Central Asian microfinance sector is young, with institutions having a median age of 5 years. The benchmarking study examined 60 MFIs located throughout the region, which had an average loan size of USD 350. The study focused on 22 of the largest MFIs, which constitute the Microbanking Bulletin (MBB) data set. Because the study uses standardized and adjusted data, its findings are the most accurate reflection of MFI performance.

The last 3 years have been a time of rapid growth for the region's microfinance sector, with a near doubling of clients. The majority of this growth, however, has resulted from the growth of larger institutions and the data shows that most institutions that "start small, stay small."

Financing

The region has limited commercial funding and this funding is directed mainly to institutions that have average loan balances per borrower that are higher than the sector average. Uzbekistan has the least access to commercial funding, largely due to an absence of a supporting legal framework for foreign investment. Kazakhstan and Kyrgyzstan have the most commercial financing to microfinance providers. The majority of microfinance providers in each country rely on equity funding, the effective cost of which is not very different from commercial sources.

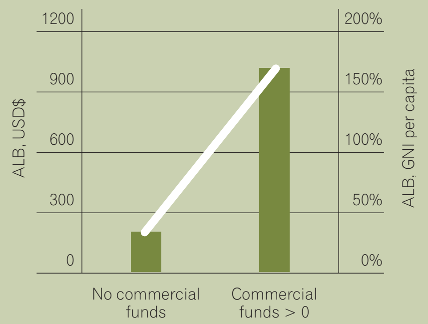
Savings mobilisation is nearly non-existent in the region, as very few microfinance providers meet the regulatory requirements for deposit-taking. Those institutions who do offer savings facilities have average loan balances per borrower that are higher than the sector average.

Depth of outreach

Recent growth has not led to microfinance providers targeting more high-income clients, although credit unions and downscaling banks in general reach higher income markets. NGOs and other institutions that use group lending models have much deeper outreach than institutions using individual lending models. Somewhat paradoxically, smaller institutions working in rural areas have larger average loan balances per borrower than larger institutions, probably because these larger institutions were founded to address broader development objectives.

Balanced growth in the sector may be achieved through mergers or through the use of smaller institutions as outreach providers for larger institutions. Additionally, apex bodies such as the investment forum Kazmicrocreditinvest JSC have been created and may facilitate growth of the sector.

GRAPH 1: ALLOCATION OF COMMERCIAL FUNDS TO CENTRAL ASIAN MFIs



Source: Microfinance Information Exchange, Inc., 2005; adjusted data.

Profitability and sustainability

In the aggregate and despite their young age, Central Asian MFIs generally have high profit levels, although the range is quite broad – unadjusted operational self-sufficiency ranges from 10% to 300%. Within the Eastern Europe and Central Asia region, only the Balkans have similarly high levels of self-sufficiency.

The high margins observable in the sector are a reflection of low competition, which allows institutions to charge high interest rates. The highest returns can be seen within NGO microfinance providers, who also have the highest revenues and expenses.

Smaller institutions that are scaling up are not necessarily becoming more sustainable, because they have limited access to funding and often are prone to underestimating the additional costs of scaling up.

Revenue and expenses

Central Asia has portfolio yields among the highest in the world, which are an indicator of the lack of competition in the sector. Yield levels for benchmarked MFIs are around 47%. In the more open markets of Kazakhstan and Kyrgyzstan interest rates are lower (<30%) than they are in Tajikistan and Uzbekistan.

As they scale up and mature, the larger benchmarked institutions realize lower yields and expenses. Partly because they receive less external support, smaller institutions do not enjoy the same gains to scale as their larger counterparts.

Expenses equal approximately 23% of assets for the region, with personnel costs representing

CONTINUED ON PAGE 5

POLAND

Demand for Microcredit among Low-Income Households in Poland

Michał Matul
Researcher, Microfinance Centre for CEE and NIS (MFC)

This note presents findings of a microcredit market study conducted for the European Investment Fund (EIF) by the MFC and Ipsos Polska. The study aims to assist EIF JEREMIE's market gap analysis initiative to facilitate the design of microcredit and other instruments to support the microenterprise sector in Poland.

Low-income households and their vulnerability

As many as 40% of surveyed low-income households are located in rural areas, nearly 25% in small towns (those with a population of up to 50,000) and a little over 20% in large urban centres. As expected, heads of low-income households have significantly less education than the national average.

Low-income households are vulnerable to risks. For as many as 61% of these households, a series of three minor sicknesses for any household member during one month causes a significant decrease in living standards in the given month. Only 7% of these households do not feel any financial pressure associated with a series of minor health problems. Low-income households with self-employment activities are vulnerable to emergency risks to the same extent as other low-income households.

Life-cycle events also create significant financial pressure, because low-income households rarely prepare for them and very often are obliged culturally to contribute a certain, non-negotiable level of money toward such expenses. Lack of financial planning and lack of access to formal credit services result in costly financial decisions. Low-income people borrow more for such events as weddings and purchase of physical assets than for life cycle events that yield financial returns in the future, such as education and housing purchases.

A large portion of low-income households manage emergency and life-cycle risks in a reactive manner. Only 35% strongly believe that it makes sense to plan finances and save money. Others are either indifferent or strongly against proactive ways of managing money, and generally do not engage in financial planning or saving. Almost half of the households surveyed never put aside money to meet future expenses, and only 15% regularly save money to meet such expenses.

Lack of long-term financial planning for old age is even more pronounced. Overall, only 21% of all households surveyed save money for old age, and only 12% of households headed by individuals between the ages of 19 and 39 do so. Neither salaried workers nor microentrepreneurs generally save for old age. Failure to save for old age is particularly risky for microentrepreneurs, as their contributions to the social security system are minimal and their pensions will generally be very low.

Needs of microenterprises for external financing

Lack of capital is one of the most important challenges for 56% of current microentrepreneurs and 35% of those aspiring to be microentrepreneurs. Moreover, respondents considered access to finance the most important of several specified incentives to open an enterprise. 21% of respondents mentioned non-repayable grants and 16% low-interest loans as key factors that might encourage them to start a business. For almost half of surveyed households, lack of funds is the most important factor preventing them from engaging in economic activities.[1]

Current use of external financing sources

Use of microcredit by current microentrepreneurs is very limited. Only 21% of surveyed microentrepreneurs have ever used any formal source of microcredit, and only 15% of those currently have an outstanding microloan.[2] None of the surveyed microentrepreneurs used services of existing microcredit organizations or local funds. Banks are the primary source of business loans, and 94% of surveyed entrepreneurs have borrowed from banks. In addition, 3% have borrowed from credit unions and 6% from local labour offices.

Only 4% of current entrepreneurs have received a grant or preferential loan, which demonstrates the limited accessibility and visibility of these programs.

7% of current entrepreneurs who have never used external financing for their businesses have applied for and been denied credit. The most common reasons for denial were lack of collateral and insufficient business plans.

Interestingly, 28% of surveyed households with microenterprises use credit cards, demonstrating that microentrepreneurs, particularly those in relatively large towns, quite often use credit cards to smooth their short-term business cash-flows.

Microcredit market

The study considered the market for microcredit in Poland to consist of 1,977,232 individuals operating or potentially operating microenterprises and start-ups. All other low-income households were deemed to be outside the market, either because they are not eligible for microcredit or because they objectively do not need microcredit.[3]

The total value of the microcredit market, estimated on the basis of the average loan size of those microentrepreneurs who are currently accessing it, is USD 12 billion, including USD 1.63 billion relating to the existing microenterprise market and USD 10.4 billion relating to the start-up market.

There are four zones within the market:

• *Penetrated market zone* – Consisting of current users of microcredit, equal to 3% of the total market and 22% of the existing microenterprise market.

- *Market enablement zone* – Consisting of low-income households that currently could be reached with new microcredit products that are demanded by enthusiastic consumers, equal to 9.3% of the total market. 70% of this zone is composed of start-ups.

- *Market development zone* – Consisting of low-income households that potentially could be reached, if new products are adapted to their needs and effective marketing strategies and an enabling environment are in place. Reaching these households also requires providing necessary incentives and conditions for them to realize their aspirations for self-employment. This zone represents the largest share of the total market, at 78.6%, and it is composed primarily of start-ups.

- *Market redistribution zone* – Consisting of low-income households that currently can not be reached by the market because, although they would like to access microcredit, they cannot afford it. To reach these households, the government must extend appropriate subsidies and adequate incentives to enable them to benefit from microcredit. The size of this group is similar to the market enablement zone and is composed mostly of start-ups.

Conclusions

- It is important to study households when researching the market for microenterprise because household finances and microenterprise are closely related and often interchangeable.

- Low-income households are vulnerable to risks and in a majority of cases cope with them in a reactive manner.

- One-third of low-income households have members who run microenterprises or who have plans and/or potential to become self-employed. Therefore, microcredit has a potential to serve large numbers of low-income households and support them in seizing economic opportunities and improving living standards.

- There are significant needs for external financing of microenterprises, as lack of capital is one of the most important challenges for current entrepreneurs and those aspiring to be self-employed.

- Low-income households generally are not over-indebted, thus their capacity to take additional business debt is not limited by household debts.

- Few current microentrepreneurs use external financing for their businesses at the moment.

- Current and potential entrepreneurs know little about microcredit and are not aware of microenterprise finance providers.

- In spontaneous discussions, most current and potential microentrepreneurs state that they think of formal external financing of their business as a last resort. On the other hand, they have a positive attitude towards microcredit and a real interest in accessing microcredit when they are given the opportunity. We might conclude that their concerns about external financing are due to their limited knowledge of good enterprise finance instruments and do not affect their interest in microcredit.

- Current and potential entrepreneurs are willing to pay market interest rates for microcredit services. If microcredit is accessible, flexible, transparent and simple to use, they are not concerned with price.

- The microcredit market in Poland is sizeable – totaling up to 1,977,232 consumers – and largely unserved. 14% of the market is composed of existing microenterprises and 86% is composed of potential start-ups.

- Low usage of external financing should be attributed mostly to the failure of supply and to the absence of market education about the options for enterprise financing. Therefore, more information and market-based products adapted to the low-income enterprise market should be sufficient to serve the market enablement zone. But a more integrated approach is needed to further develop the market.

1 On the other hand, while conducting qualitative research it was noticed that interviewees from the non-aspiring group often had an exaggerated idea of how much money is needed to start a business. Lack of funds often appears to be an easy and socially acceptable excuse that is used to conceal psychological barriers such as fear of risk and responsibility.

2 43% of those who took credit did so only once. Only 31% have taken three or more loans. The average loan amount is 18,250 zl and the highest loan amount is 60,000 zl. 50% of entrepreneurs borrowed less than 15,000 zl. The average repayment period is three years.

3 This group consists of those who have no potential for self-employment and those whose businesses do not need financing currently.

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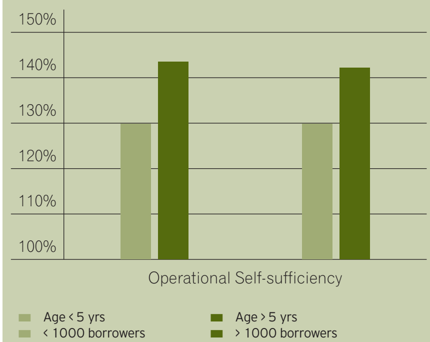
MIX and CAC Central Asia Benchmarking Study

GRAPH 2:



Source: Microfinance Information Exchange, Inc., 2005; unadjusted data.

the majority of these expenses. Poor infrastructure and dispersed populations mean that costs are higher when compared to neighbouring regions. On average, older and larger institutions have lower expenses.

Conclusions

Microfinance has a very important role in furthering access to financial services throughout the four republics in Central Asia. The development of inclusive financial services in the region still faces obstacles due to sparse population density and the absence of clear legislation adapted to microfinance services. However, there is reason to believe that the microfinance sector will continue to develop, as more and more MFIs decrease expenses and become sustainable. The mere fact that this benchmarking study was able to be carried out is a testament to the increasing capacity and support for financial transparency and sustainability within the region.

References

This article is a summary of the November 2006 publication 'Microfinance Institutions in Central Asia: Benchmarks and Analysis,' co-authored by the Microfinance Information Exchange (MIX) and the Central Asia Microfinance Center (CAC). The legal information contained within that publication has been reviewed by the CGAP Legal Initiative. Copies of the publication can be obtained at www.themix.org.

ROMANIA

The Importance of the Regulatory Framework for Development of the Microfinance Sector: The Romanian Experience

Maria Doiciu

Access to finance component leader, TA to develop the SMEs sector in Romania, Enterprise plc – Eurom Consultancy Ltd.

Why is Microfinance Legislation Needed?

Romanian individual entrepreneurs and companies with no credit history and few assets to use as collateral rarely have access to the formal financial sector. In addition, the size of loans sought by these borrowers is often too small for banks because the administrative costs of granting and monitoring such loans outweigh the benefits that banks receive from them. As a result, these borrowers often rely on alternative credit sources – such as very expensive informal commercial and non-commercial lenders – unless they have access to microfinance providers, credit cooperatives and credit unions.

In recent years, implementation of a specialized regulatory framework has fostered growth in the Romanian microfinance sector. However, clear and concise microfinance legislation establishing an appropriate level of regulation of MFIs would facilitate further development of the Romanian microfinance sector, which, in turn, would serve as a driving force to combat poverty, create jobs, increase entrepreneurship, improve social welfare and develop the micro and small enterprise (MSE) sector.

The Current Regulatory Framework for Microfinance Activities in Romania

Microfinance activities started in Romania about fifteen years ago when the first international microfinance organizations launched small and medium enterprise development and microfinance projects in Romania. Between 2000 and 2006, the microfinance sector evolved rapidly and became more efficient and productive in achieving its mission of providing credit and other services to underserved entrepreneurs. These improvements were made possible in part by development of a specialized regulatory framework.

Government Ordinance 40, effective since 2000, provides for licensing of non-profit credit agencies to on-lend public funds (e.g., World Bank loans guaranteed by the Romanian government) as microcredit to applicants, based on specific selection criteria, in order to allow them to engage in economic activities.

Micro Finance Companies Law No. 240, adopted by the Romanian Parliament in July 2005, creates an enabling environment for micro finance companies (MFCs) to grow and expand their portfolio of products and support services. Under the law, MFIs registered as MFCs can provide credit up to 25,000 euros to entrepreneurs and micro and small enterprises for financing economic activities and business development.

Government Ordinance 28, in force since January 2006, regulates the conditions for non-bank microfinance institutions (NBMFIs) to grant loans in order to ensure and maintain financial stability. Importantly, the ordinance makes the National Bank of Romania (NBR) the supervisory authority for all NBMFIs. The ordinance also expands the range of beneficiaries of microcredit to include individuals and consumer borrowers. NBMFIs are defined to include all non-bank financial service providers: MFCs, leasing companies, mortgage lenders, credit unions and guarantee funds.

The existing legal framework recognizes the microfinance sector as part of the Romanian financial sector and incorporates general microfinance principles, taking into account Romanian legal, economic and cultural factors in the following ways:

> One of the main constraints on micro and small enterprises in Romania is the lack of access to finance, which is particularly significant for start-ups and microenterprises.

- **Minimum capital designed to ensure self-sustainability of MFCs**
  Romanian law requires a minimum capital of 200,000 euros for MFCs. This minimum capital requirement is warranted by the economies of scale in Romanian microfinance, as below this threshold an MFC may not be able to support the necessary infrastructure and still operate profitably without donor

funding. Under this requirement, MFCs are forced to be more efficient in order to lower the operational costs of their activities and achieve desired self-sufficiency.

- **Limited regulatory barriers for market-entry of MFCs**
  MFCs face low barriers to entering the microfinance market. The legal framework does not impose limitations on foreign ownership, management or capital. This is especially true now that Romania has begun to integrate into the European Union following its January 1, 2007, accession.

- **Consumer protection**
  Two consumer protection issues are particularly relevant to microfinance and warrant attention:
  (1) protection of borrowers against abusive lending and collection practices, and
  (2) "truth in lending," or the provision to borrowers of accurate, comparable and transparent information about the cost of loans.
  Generally, the absence of standards for transaction fees and interest calculation methods makes it difficult for borrowers to compare costs when choosing a microfinance lender. For this reason, Romanian law requires MFCs to disclose to applicants the interest rates and other material terms and conditions of the microcredit contract prior to conclusion of the contract.
  This disclosure requirement is designed to help applicants evaluate the true cost of borrowing, and to promote price competition in the microfinance market. In addition, the requirement and resulting competition may help focus MFCs on steps they can take to increase efficiency and thus lower interest rates.

- **Credit information**
  The Romanian legal framework explicitly provides for the right of microfinance providers to exchange and share information on the credit history of borrowers, using the Central Banking Risks Office, the Credit Bureau or other credit agencies, public or private.
  Credit information services offer important benefits both to financial institutions and to their customers. By collecting information about clients' credit history, lenders may lower their risks. Customers may use their good repayment record with one lender as a means to gain access to credit from another MFC or bank. Moreover, the experience in other countries suggests that when MFCs begin to compete with each other for customers, over-indebtedness and default will rise sharply unless MFCs have access to a database that captures relevant aspects of their clients' credit history.
  At the same time, available credit history may allow MFCs to be much more aggressive in lending without collateral and may also have a beneficial effect on competition among lenders. The combination of credit bureaus and statistical risk-scoring techniques has expanded lower-income groups' access to credit.

- **Access to public funds**
  One of the main constraints on micro and small enterprises in Romania is the lack of access to finance, which is particularly significant for start-ups and microenterprises. In addition, the governmental bodies empowered to manage and distribute public funds find it difficult to channel these funds to the end users, the microentrepreneurs. This contributes to the MSE sector's inability to absorb and make best use of the public funds received from international donors.
  The legal framework has enabled MFCs to access public funds, thus creating competition between the credit agencies (NGOs) and the

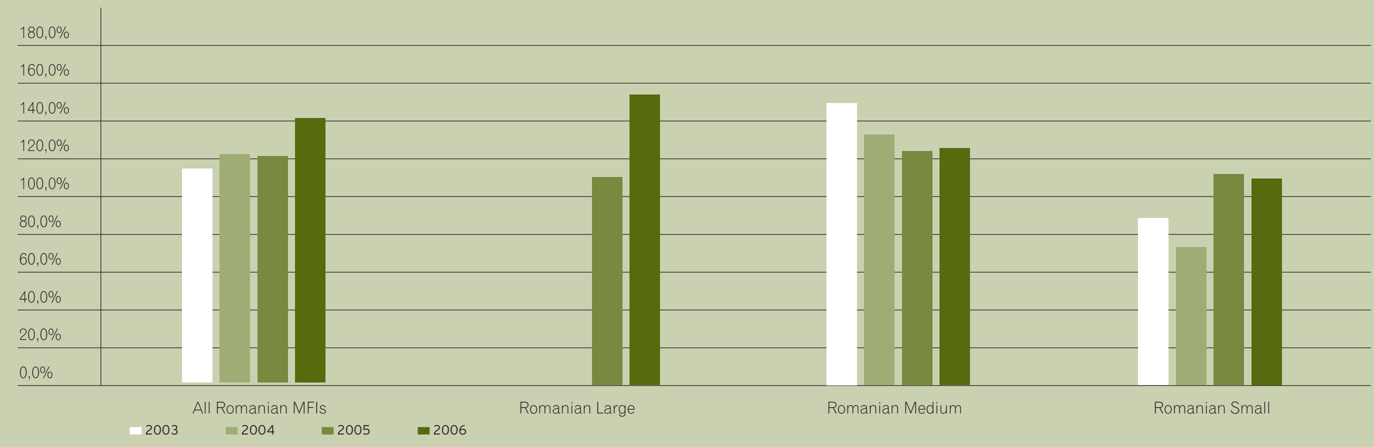
TABLE 1: FUND SIZE

Romanian Large Gross Loan Portfolio > EUR 5,000,000 Target: High-End	
a) in 2005	CAPA Finance, Express Finance (CHF)
b) in 2006	CAPA Finance, Express Finance (CHF), OMRO, CDE
Romanian Medium Gross Loan Portfolio = EUR 1,000,000 - EUR 5,000,000. Target: Broad	
a) in 2005	OMRO, ROMCOM, LAM, FAER, CDE
b) in 2006	LAM, FAER, ROMCOM, Interomega, Pozitiv
Romanian Small Gross Loan Portfolio < EUR 1,000,000 Target: Low-End	
a) in 2005	Integra
b) in 2006	Integra, Aurora, Tomis, 10 newly established MFIs
Legal structure	
NBMFI	CAPA Finance, Express Finance (CHF), FAER, Integra, LAM, OMRO, ROMCOM, Aurora, Tomis, Interomega, Pozitiv, 10 newly established MFIs
NGO/Foundation	CDE
MFI mission, targeted market and services offered	
Socially oriented	Integra, ROMCOM, CDE
Socially and commercially oriented	CAPA Finance, Express Finance (CHF), LAM, FAER, OMRO
Commercially oriented	Aurora, Tomis, Interomega, Pozitiv, 10 newly established MFIs

TABLE 2:

Indicator	2003	2004	2005	2006[2]
Number of MF Organizations	14	14	9	22
% Country outreach	60%	80%	85%	100%
Numbers of loans	8400	14900	20000	30000
Average loan (euros)	3100	3400	5200	6000

GRAPH 1:



MFCs, and this will increase the use of public funds and ease the MSEs' access to finance.

The Current State of the Romanian Microfinance Sector

As demonstrated by the following statistics, the legal framework in place currently in Romania has contributed significantly to the development of the microfinance sector.

The MFIs included in this assessment are categorized as small (less than 1 million euros gross loan portfolio), medium (between 1 and 5 million euros) and large (greater than 5 million euros) organizations trending towards continued growth. They include both MFCs and MFIs that have not yet registered as MFCs.

2006 allowed for exceptional growth in the Romanian microfinance sector, and at the end of the year four MFIs succeeded in graduating into the "large" category. The trend continues in 2007, mainly due to the large investment in the sector of the EU, the Romanian Government and EBRD[1].

Following Romania's accession to the European Union, the sector is facing new challenges. There is an increased demand for financial services from the MSE sector. This is demonstrated by the estimated unmet demand for 2007, which is projected at over 700 million euros.

For the last three years, medium and large Romanian MFIs demonstrated operational self-sufficiency, and since 2005 they have demonstrated financial self-sufficiency. This performance compares favorably to the All MFIs[3] peer average of 119%. Due to the fact that in Romania donations and grants are no longer widely available, Romanian MFIs will continue to monitor profitability and sustainability indicators as well as the quality of their portfolio.

It is important to note that in 2006 the average retention rate in the system was about 90%, which means that clients were pleased with the financial services provided by MFCs.

Development Prospects

Due to the new legal framework, the Romanian microfinance sector is divided into two distinct segments. The first is a mature one, efficient, operationally and financially self–sufficient and attractive to lenders. The second is composed of a large number of new MFIs, registered or in the process of registering as MFCs. These MFIs are immature and need specialized technical assistance and training in order to successfully integrate into and contribute to the sector.

It seems that the commercialization strategy pursued by most of the MFIs in 2004 is beginning to pay off. The development of the sector – measured in terms of geographical outreach, increased efficiency, productivity and profitability – is a good indicator that the strategy adopted by these MFIs is working. However, faced with the need to be more and more profitable, a large number of MFIs are struggling to maintain their social orientation.

Moreover, the sector is subject to the European challenge to achieve the triple bottom line, which requires continuous improvement of the quality of services provided to targeted clients and social responsibility towards staff, clients, community and the environment.

Lessons Learned

Two lessons can be learned from Romania's experience with the creation of an effective regulatory framework for microfinance. First, a clear, coherent and supportive legal framework is necessary for the development of the microfinance sector. Prior to 2000, the Romanian microfinance sector was not regulated at all. It was then well-regulated for a short period in 2005 following the enactment of the Micro Finance Companies Law. However, since the 2006 enactment of Government Ordinance 28, the sector has been over-regulated. It has been supervised strictly by the NBR and the Ministry of Finance, based on rules that were designed for the banking sector rather than the microfinance sector.

Another lesson learned is the importance of continuously lobbying stakeholders to make them aware of the sector's most important characteristic: efficient financial services with positive social and developmental impact.

This awareness-building will be helped by the participation of representatives of the Romanian microfinance sector in the EU-funded project called, "From Exclusion to Inclusion through Microfinance: Learning from East to West and from West to East."

The Romanian representatives are learning from their Western European peers how to assess the social impact of microfinance activities and how to maintain the social mission of microfinance by improving and diversifying the financial and business development services offered.

1 The 80 million euro microcredit scheme for start-ups and microentrepreneurs implemented by EBRD was launched in December 2006.
2 The contribution of about 20 newly established MFIs is estimated.
3 Microfinance Information Exchange, "Benchmarking Microfinance in Eastern Europe and Central Asia," May 2004.

UN Advisors Group on Inclusive Financial Sectors

Grzegorz Galusek

Executive Director, MFC

In 2006, the UN appointed a group of experts to advise the United Nations system and member states on global issues relating to building inclusive finance. The Advisors Group consists of 25 individuals representing governments, central banks, regulatory agencies, private sector financial institutions, development agencies, microfinance institutions, international networks (including MFC) and academics from all over the world. Her Royal Highness, Princess Maxima of the Netherlands is also a member of the Group.

The Advisors Group works with key stakeholders (such as the private sector, central banks, governments, academia, etc.) to identify and define the key issues constraining access for financial services and advises the UN regarding strategies that can be undertaken to remove the constraints to building inclusive financial systems. As part of its mandate, the Group has drafted the following key messages regarding basic principles in building financial systems that include low-income people.

KEY MESSAGES FOR GOVERNMENTS, REGULATORS, DEVELOPMENT PARTNERS AND THE PRIVATE SECTOR

Target Audience

Governments	Regulators	Private Sector	Development Partners
• Inclusive financial sectors require building and supporting permanent, local financial institutions and embracing new technologies and systems that deliver a diverse range of financial products and services to the poor. • Each government's vision for a well-functioning financial system should include access for all citizens to a broad range of financial products and services,including savings, credit, insurance, and money transfers. • The role of government is to create a helpful policy environment that broadens access while protecting consumers. When the government itself provides financial services, politics almost always limit access. • Governments should refrain from imposing interest rate ceilings, as they may limit credit expansion and shift the cost burden to hidden fees. The best way in which governments can encourage the lowering of interest rates is to promote transparent prices and an open, competitive market. • Broadening access to financial services is an important policy goal, but will not in and of itself eliminate poverty.	• Financial inclusion should be a major objective of financial regulation. The role of regulators is to establish environments that allow a diverse range of institutions to provide a wide variety of financial products and services. • Regulators must be flexible in their approach; they must mitigate risks without limiting access to financial services. • Regulators must assure appropriate supervision of both financial services providers and their supporting industries, such as telecommunications. • Regulators must exercise caution that anti-money laundering and related regulations do not block access to financial transfers that are critical for poor people. • Broad-based access to financial services requires an enabling regulatory environment for telecommunications and technology infrastructures.	• Providing financial products and services to poor people represents a large business opportunity for the private sector. Providers of financial products and services should use their strengths to develop a range of products that better serve the needs of the poor. • The private sector has an important role to play in expanding access to financial services for poor people. • Private sector participants in inclusive financial sectors should include not only direct providers of financial products and services, such as banks, insurers and money transfer companies, but also telecommunications and technology companies, credit bureaus, retailers and other private sector entities that support the financial services industry. • For the private sector to realize the market opportunity of expanding access to financial services, it must be engaged in establishing appropriate enabling environments. • The private sector can expand access to financial services in many ways. These include providing capital; building infrastructure; developing new products, services and technologies; and improving human and institutional capacity.	• For development partners, quality of funding for inclusive finance is at least as important as quantity. Good funding requires technical expertise and appropriate funding instruments. • The key bottleneck for development partners supporting inclusive finance is the shortage of strong institutions and managers. • Development assistance for inclusive finance should complement private sector activities, not compete with them. • Better information on the performance of development partner investment portfolios is essential. What is not measured cannot be managed. • For development partners, both an effective division of labor and coordination of efforts are needed for maximum efficiency and impact of development assistance on inclusive finance.

Branchless Banking Through Retail Agents: Risks and Regulation

LEE BYRD

POLICY ADVISORY CONSULTANT, CGAP

This article is based upon research and publications relating to CGAP's ongoing efforts in the area of branchless banking. CGAP's Focus Note 38, which contains a detailed discussion of regulatory issues relating to branchless banking, can be found at www.cgap.org.

Across the globe, financial service providers have begun to offer a wide range of financial services to poor customers through models of delivery collectively referred to in this article as branchless banking. Under these models, financial service providers deliver banking and payment services through "agents" acting on their behalf. These agents may be postal or retail outlets, including grocery stores, pharmacies and gas stations.[1]

Branchless banking has the potential to expand greatly access to formal financial services for poor and hard-to-reach customers. But because branchless banking is a relatively new concept developing at an extremely rapid pace, it is important to understand and assess the models that have arisen and the regulatory risks that each presents to ensure an appropriate balance between expanded access and protection of the interests of vulnerable customers.

Two broad models of branchless banking have emerged in recent years. Both models utilize information and communications technologies to process and deliver transaction information, but they differ in important ways and present different regulatory concerns.

In the first model, referred to as the bank-led model, a bank or some other form of licensed financial institution delivers financial services through a network of retail agents using technologies – typically mobile phones or point-of-sale devices equipped with card readers – that allow them to communicate directly with the financial institution. The bank maintains the customer's account but the bank's retail agents, rather than employees of the bank, actually deliver financial products and conduct all or some client transactions.[2] In some countries, retail agents also open accounts and identify and service loan customers.

In Brazil, banks have used a form of this bank-led model to greatly expand the delivery of financial services to the poor, particularly in remote areas that previously lacked formal financial institutions. In 2000, according to a World Bank report, more than one-fourth of Brazil's 5,800 municipalities lacked access to formal banking services. By 2003, all of these municipalities had access to such services through retail agents acting on behalf of private and state-owned banks in supermarkets, pharmacies, post offices and lottery kiosks.[3]

In the second broad model of branchless banking, the nonbank-led model, a commercial entity that is not licensed by the related financial regulator, typically a mobile network operator or stored value card issuer, provides financial services and retail agents are responsible for all customer interaction. Rather than conduct individual transactions in cash, customers exchange cash for "e-money" that is stored in a virtual account maintained on the server of the commercial entity. This e-money can then be used for a range of transactions, including payments and remittances, purchases and savings, and can be converted back to cash at any time by a participating retail agent.

In the Philippines, mobile network operators have offered financial services through nonbank-led branchless banking since 2000. Globe Telecom, for example, offers "G-Cash" e-money accounts associated with a mobile phone subscriber information module (SIM card). G-Cash customers can use their virtual accounts to conduct all of the transactions described in the preceding paragraph, and can access their accounts at a wide range of retail agents and at Globe Telecom's own dealers. Approximately one million Globe Telecom subscribers currently have a G-Cash account.

Policymakers have begun to recognize the tremendous opportunity that branchless banking presents to expand access to safe financial services for the poor. In addition to Brazil and the Philippines, policymakers in India, Kenya and South Africa have allowed for branchless banking initiatives, and in several other countries are currently considering questions relating to regulation of branchless banking. In Russia, as described below, the Bank of Russia has chosen not to regulate heavily the development of the branchless banking market.[4]

As initiatives like those in Russia move forward, regulators have worked to address new regulatory risks presented by each model of branchless banking. From a regulatory perspective, the bank-led model differs from traditional banking primarily because the bank essentially outsources client contact to a potentially very large number of retail agents. This adds an additional layer to each transaction and presents additional risks not only to customers, but also to retail agents and the banks for which they act. For example, agent-assisted transactions require communications between the retail agent and the bank, and the possibility of unsuccessful communication presents credit risk to the customer, as well as to the retail agent and the bank. Similarly, the use of retail agents increases:

- operational risk (including fraud) from "inadequate or failed internal processes, people and systems;"
- legal risk from uncertainty about legal and regulatory treatment;
- liquidity risk from the participation of unsophisticated and remote retail agents; and
- reputational risk from poor performance resulting from the above categories of risk.

The nonbank-led model is subject to each of these risks, but also presents potentially more significant risks arising from the acceptance of repayable funds from retail customers by unlicensed and unsupervised commercial entities. Without oversight, such an entity is more likely to steal money that a customer deposited with it in exchange for e-money, and is more likely to mismanage funds, become insolvent and fail to honor its obligations to customers. Nonbanks often store the net proceeds of e-money issuances with a licensed and prudentially supervised bank, and this can help to maintain liquidity to honor customers' claims. Although such a measure by itself does not protect customers against fraud, mismanagement or insolvency, these risks will be mitigated to the extent that the proceeds are held in trust by the bank for the benefit of the customers.

In both models, the outsourcing of banking functions to retail agents also raises consumer protection concerns beyond those present in traditional banking. Customers may have more difficulty understanding and enforcing their rights when conducting substantially all of their transactions with retail agents rather than directly with a bank. Although customers are generally protected against fraud by laws and regulations, customers may not understand how that protection applies when they use retail agents to conduct financial transactions.

Finally, both models raise concerns relating to anti-money laundering and combating financing of terrorism (AML/CFT). Under AML/CFT regulations, retail agents may be responsible for performing customer due diligence and conducting suspicious transactions reporting. However, these duties may not be fully and properly executed when performed by unsophisticated or unprofessional retail agents. The bank bears the risk that a failure on the part of its retail agent – with or without the retail agent's knowledge – allows for money laundering or financing of terrorism.

Regulators in countries already experimenting with branchless banking have taken various approaches to mitigating risk. In both Brazil and India, in which branchless banking has followed the bank-led model, regulators have made banks fully liable for the actions of their agents and have given supervisors the authority to review agent transactions and records, just as they would have if the transactions took place on bank premises. In addition, in Brazil the central bank can examine the process a bank uses to select its retail agents, and in India only specialized MFIs and post offices are permitted to act as retail agents.

In South Africa, banks are subject to specific requirements when they outsource banking functions to retail agents and they are responsible for the actions of their agents under common law principles of agency. Retail agents can take deposits on behalf of a bank, but the bank is held entirely responsible as principal for the actions of its agents. South African regulators have also prohibited the issuance of e-money by nonbanks.

In the Philippines, regulators and Globe Telecom agreed on a creative approach that gave Globe regulatory status as a remittance agent, which allowed Globe to avoid seeking a banking license to take deposits. As a remittance agent, Globe is subject to AML/CFT laws as well as central bank imposed limitations on the use of G-Cash. Customers cannot hold e-money balances above P10,000 (approximately USD 206) at any time or transact more than P40,000 per day and P100,000 per month (approximately USD 826 and USD 2,064, respectively). These limitations ensure that customers do not use G-Cash primarily as a deposit account and cap the amount of money that an individual customer could lose in the event of a Globe bankruptcy.

Finally, in Kenya, the regulatory environment is not very clear and will change soon. One nonbank, Safaricom, is issuing e-money in Kenya through its M-Pesa accounts. Safaricom structured the M-Pesa product in such a way that it does not fall within the definition of banking business under Kenyan law and, therefore, can be offered even by a nonbank like Safaricom. However, the Central Bank of Kenya has made clear that this e-money service is not entirely unregulated, as the Central Bank has a broad regulatory mandate to regulate M-Pesa as a payment system provider. This mandate will become much more specific when the pending National Payment System Act has been enacted.

Regulation of branchless banking is a relatively new concern, but the experiences of the five countries described above appear to demonstrate that approaches are available that can mitigate the new and enhanced risks involved. As more countries experiment with branchless banking and its regulation, appropriate responses will become more clear and, hopefully, make possible the expansion in access to financial services that it promises to deliver.

Agent-Assisted Branchless Banking in Russia

In the early 1990s, Russia adopted very restrictive banking legislation that allowed only regulated credit institutions to provide banking services such as deposit-taking, credit and payment services. Partly for this reason, branchless banking in Russia is a relatively new phenomenon and to date has had little impact on access to financial services. However, in recent years, use of both bank-led and nonbank-led models of branchless banking has expanded rapidly.

More than two years ago, the first examples of the nonbank-led model emerged in Russia. At that time, although the law did not provide for branchless banking, mobile network operators began to offer customers virtual accounts that provided deposit-taking and payment services. More recently, Russia has seen a rapid expansion of web-based and stored value card systems, which provide payment services only.

Beginning in 2006, amendments to the banking legislation provided for bank-led branchless banking for certain payment services, and made banks fully responsible for the actions of their agents. Banks began to use retail agents to accept rent, utility, telephone and internet payments from the public, and use of this service grew quickly. Following implementation of the amendments, some commercial entities providing nonbank-led branchless banking began to partner with licensed credit institutions in order to comply with the law.

The Bank of Russia, which is responsible for regulation of the Russian financial system, has not taken an aggressive approach to regulation of branchless banking, and regulation has not kept pace with market and technological developments. Currently, the Bank of Russia's official position appears to be that more research into regulatory issues should be conducted and additional regulation of branchless banking is not immediately necessary because its use is limited and poses little threat to the financial system.

Russia's strict anti-money laundering legislation potentially makes the provision of branchless banking impractical. The legislation requires direct customer identification by bank employees and does not make any exceptions based on the nature, size or volume of financial transactions. This legislation is a major barrier to offering remote customer services through branchless banking. In practice, however, the legislation is not strictly enforced, particularly in the areas in which new financial and communication technologies are most commonly used.

1 These postal and retail outlets are referred to in this article as "retail agents." They generally are not "agents" in a legal sense, but do perform cash-in and cash-out functions (for which they are not themselves licensed) on behalf of banks or e-money issuers.

2 Models using mobile phone technologies generally require retail agents only to conduct cash-in/cash-out transactions. Other functions can be performed without the use of a retail agent.

3 Kumar, Anjali, Ajai Nair, Adam Parsons and Eduardo Urdapilleta. "Expanding Bank Outreach through Retail Partnerships: Correspondent Banking in Brazil." World Bank Working Paper No. 85. Washington, D.C.: World Bank.

4 Oleg Ivanov, an expert with the State Duma's Committee on Credit Organizations and Financial Markets, provided information regarding branchless banking in Russia.

KAZAKHSTAN

Enhancing Microfinance Legislation:

The Experience of the Association of Microfinance Organizations of Kazakhstan

Saltanat Igenbekova

Association of Microfinance Organizations of Kazakhstan (AMFOK)

The Law of the Republic of Kazakhstan on Microlending Organizations (Microlending Law) was adopted in March 2003 in order to accelerate development of the non-banking credit sector as a source of credit for the general public, especially small and medium entrepreneurs.

The Microlending Law simplified procedures for providing microloans in the Republic of Kazakhstan (the Republic), which made them a more attractive tool for financing small and medium enterprises.

During the last three years, the microfinance industry in the Republic has grown significantly, partly in response to a changing economic situation but also because of considerable amendments to the Microlending Law. These amendments were initiated by the Association of Microfinance Organizations of Kazakhstan (AMFOK)

AMFOK is an organization whose objective is to protect the interests of and enhance the regulatory framework for microfinance in the Republic. At its conference in August 2005, AMFOK proclaimed the need for further development of microcredit in the Republic and appropriate amendments to the Microlending Law, because existing law was no longer meeting the requirements of small entrepreneurs and restrained the development of their businesses.

As a result of AMFOK's efforts, the following amendments were made to the Microlending Law:

Amendments to the definition of "borrower"

Under the previous version of the Microlending Law, only small entrepreneurs had access to microcredit organizations. This excluded a large part of the population that had no access to formal financial institutions, including salaried workers from private and public companies (especially in small towns and in rural areas), market vendors and rural entrepreneurs.

In order to provide financial access to these groups, the definition of the term "borrower" was amended to include individuals, which allows microlending organizations to provide services to a wider population – including the poorest members of society and rural people – thus increasing their living standards.

Increasing the amount of microloans

According to the previous version of the law, the maximum loan amount per borrower was 1,000 monthly units, equivalent to approximately USD 8,200. This amount was much lower than the real cost of starting up and developing a small business and was not in the best interests of microentrepreneurs.

With this in mind, AMFOK proposed increasing the maximum loan amount to 8,000 monthly units, equal to approximately USD 67,000, which would increase the attractiveness of microcredit organizations to small entrepreneurs and allow them to develop their businesses.

Of course, microcredit organizations will have the right to disburse loans for amounts less than the maximum amount, including for various poverty alleviation programs. Such an opportunity will allow them to expand their lending to small businesses, including in rural areas, which should provide new opportunities to entrepreneurs to develop and expand their businesses.

On December 8, 2006, the President of the Republic enacted the amendments to the Microlending Law. It was an important achievement for both AMFOK and the Republic's microfinance sector as a whole. The amendments will have significant social impact, helping to improve living standards, especially for socially vulnerable members of the population, and should facilitate further development of small and medium businesses.